

**CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF INVESTMENT POLICY**

**FOR
SPECIALIZED (OR "NON CORE") EQUITY REAL ESTATE**

August 18, 2003

This Policy is effective immediately upon adoption and supersedes all previous specialized real estate investment policies.

I. PURPOSE

This document sets forth the investment policy ("the Policy") for the Specialized (or "Non Core") Equity Real Estate Portfolio ("the Portfolio"). The design of this Policy ensures that investors, managers, consultants, or other participants selected by the California Public Employees' Retirement System ("the System") take prudent and careful action while managing the Portfolio. Additionally, use of this Policy provides assurance that there is sufficient flexibility in controlling investment risks and returns associated with this segment of the real estate portfolio.

II. STRATEGIC OBJECTIVE

Achieving the highest total rate of return possible, consistent with a prudent level of risk, the liabilities of the System, and the investment guidelines contained herein, is the strategic objective of the Portfolio. The System's Non Core Portfolio is generally expected to produce higher returns than the Core Real Estate Portfolio or to fulfill specific targeted investments with acceptable returns. Furthermore, the Portfolio is expected to increase the overall performance of the Equity Real Estate Portfolio, subject to an incrementally greater amount of risk. Additionally, specialized portfolio investments should diversify the systematic risk (or other characteristics or both) of the Core Portfolio.

The Non Core Portfolio consists generally of investments with expected returns in excess of the Core Portfolio and above market risk. These investments are often found in niche opportunities (e.g., timber or hotels) or exist because of inefficiencies in the real estate or capital markets. Additionally, the Non Core Portfolio may contain investments in special purpose properties with a narrow user market (e.g., mobile home parks).

Investment strategies for the Portfolio shall be characteristically "opportunistic," based on prevailing market conditions at the time of

investment. Specific policies shall be developed as necessary, to take advantage of specialized real estate investment opportunities as they arise. Some examples of specialized real estate investment programs include, but are not limited to, investment strategies focused on the following:

- A. Developmental properties;
- B. Timber land;
- C. Agricultural land;
- D. Urban real estate initiatives;
- E. Hotels and motels;
- F. Franchise finance net leased properties;
- G. International real estate.
- H. Senior Housing;
- I. Real estate technology;
- J. Real estate private equity;
- K. Opportunistic Investments; and
- L. Single family housing program.

(See Appendix I for a list of Portfolio Policies.)

Investments shall be subject to the Statement of Investment Objectives and Policies for the Equity Real Estate Investment and the Delegation and Approval Guidelines, which are incorporated by, referenced hereto. The Portfolio Policy is an elaboration of Section VIII.D, "Specialized Portfolio," of the Statement of Investment Objectives and Policies for the Equity Real Estate Investment.

III. PERFORMANCE OBJECTIVES

The Non Core Portfolio shall be expected to achieve a minimum, long-term, real rate-of-return that is consistent with the overall objectives of the Equity Real Estate Portfolio and may be reflective of higher levels of risk, often characteristic of its constituent investments, as appropriate.

Investment selection should be oriented to the preservation of capital and achievement of real rates of return.

The performance of the specialized investments shall be compared to U.S. equity real estate benchmarks (the NCREIF or WRESI indices) and target returns in excess of the minimum 5% overall real-return objective for the U.S. Core Equity Real Estate Portfolio. When appropriate, customized benchmarks shall also be developed for these investments, taking into account specific risk attributes of the investments, (e.g., the international and timber sectors).

Within the Portfolio, expected returns may vary considerably, but shall be set individually for each investment program at the time of approval. Investments included in the Portfolio are also likely to generate limited current income. The bulk of the return on these investments is expected to come from appreciation. Some programs may employ moderate-to-high levels of leverage to augment performance.

IV. INVESTMENT APPROACH AND PARAMETERS

A. Risks

There are specific risks associated with investments that shall be carefully monitored and mitigated by the System. Mitigating factors and techniques are somewhat dependent upon the individual investment program. Those risks shall be described within each investment program policy as follows:

1. **Financial** - Portfolio investments often employ a greater use of financial leverage that can lead to greater volatility in returns.
2. **Operating and Business** - Certain investments entail above average operating and business risk (e.g., hotel, senior housing).
3. **Liquidity** - Many investments carry an additional liquidity risk beyond the normal private market real estate investment liquidity risk (e.g., owning units of a commingled fund). Additionally, liquidation proceeds may compose the bulk of the return on investments.
4. **Structural** - The System negotiates and structures specific fundamental rights and protections, which include mechanisms to take remedial action. These basic protections include advisory committee participation and

specific termination provisions in partnership transactions and anti-dilution, put-and-call options, voting rights for material events, and other covenants and governance provisions for direct investments.

5. **Valuation** - Partnerships shall be evaluated by the System to determine if the general partner employs an appropriate valuation discipline.
6. **Country** - Political, economic, and currency risks associated with investing outside of the United States shall be evaluated by the System.

B. Diversification Guidelines

Capital allocations shall be primarily driven by market opportunities. The System shall seek to maintain a prudent level of diversification within and among such investments. Care shall be given to avoid undue concentrations in any one particular investment strategy.

C. Investment Size

The size of Portfolio investments shall depend on the opportunities available to the System, with neither small nor large investments dominating the Portfolio. Furthermore, investment size shall be appropriate to the projected risk versus return level of the investments. However, in order to have some affect on the composite Equity Real Estate Portfolio, preference shall be given to investments with funding commitments of \$50 million (or greater) in size.

D. Structures

The Portfolio shall be implemented primarily through direct equity investments in real estate (either 100% owned or through joint ventures or other co-investment vehicles). Equity (privately-held or publicly-traded), leveraged equity, and debt instruments with equity-like features, are also appropriate structures for investments.

E. Vehicles

1. The System shall consider a number of different vehicles for investments including, but not limited to, the following:
 - a. Equity investments in 100% owned assets;

- b. Equity joint ventures or other co-investment vehicles;
 - c. Indirect equity investments in commingled funds; private or public REITS and corporations; limited partnerships; or other pooled investment vehicles;
 - d. Private placements of equity or debt in public or private real estate operating companies; and
 - e. Lower or unrated tranches of pre-existing securitized or structured debt instruments, such as mezzanine or other debt with equity-like features.
2. In choosing specific investment vehicles for Portfolio investments, consideration shall be given, but not limited, to the following:
- a. Proposed investment strategy
 - b. Expected risk and return attributes of vehicles
 - c. Potential diversification benefits
 - d. Investment time horizon
 - e. Potential exit strategies and liquidity
 - f. Monitoring costs and feasibility
 - g. Tax considerations
 - h. Other incremental costs
 - i. Fee arrangements
 - j. Co-investment by management
 - k. Potential conflicts of interest
 - l. Governance and control
 - m. Partners or co-investors

F. Selection of Investment Managers

The System shall make investments through third-party investment advisors, general partners, operating company management teams or other organizations with specific expertise in investments (collectively referred to as "Management Firms"). Management Firms shall provide expertise and experience in locating, negotiating, monitoring, and disposing of investments. The System shall establish and document specific relevant criteria for each Management Firm before they are selected to establish the basis on which the selection shall be made. Selection of management is critical to the success of the Portfolio. The System shall approve Management Firms based on their reputation and successful history or significant potential in managing and implementing investment programs.

Management Firms and advisors for investments shall be selected by the System pursuant to the Delegation and Approval Guidelines. The Staff may recommend the use of management firms or multiple advisors for a specific investment program. Upon selection, the Staff and the advisor(s) selected shall refine and implement the investment program for the strategy, as outlined in policy documents. Management Firms shall prepare Annual Investment Plans, manage System assets, implement approved Annual Investment Plans, and provide quarterly reports in accordance with System standards.

If the use of commingled funds is selected, the Staff shall perform analysis of appropriate available commingled funds with the assistance of the consultant, as appropriate. The Staff shall make recommendations concerning their analysis of commingled funds to the Investment Committee. Investments in commingled funds may involve the use of investment advisors not previously approved by the Investment Committee.

G. Asset Management

Management Firms shall represent the System's interests in asset management decisions and oversee or provide daily property management services, as expertise and organizational structure allows, and act in a fiduciary capacity. The System shall give Management Firms the appropriate delegation of authority. Management Firms shall provide suitable measures of accountability to the System.

The System shall require that each specialized investment have investment program parameters and contractual relationships with the Management Firms selected.

The Real Estate Equity Unit and the consultant (as appropriate) shall develop investment program parameters. The parameters developed shall be subject to approval by the Investment Committee. Important program parameters include the following:

1. **Program Size** - Funds allocated to the market segment;
2. **Timing** - Target date for investment of allocated funds;
3. **Diversification** - Target allocation of funds among geographic regions and sub markets within the market segment as appropriate;
4. **Investment Guidelines** - Specification of the investment guidelines for acceptable investments within the market segment; and
5. **Asset Management** - Specification of the expected value-enhancing activities that shall result in maximizing returns to the System.

The Real Estate Equity Unit and the System's legal counsel shall have the joint responsibility for developing the contractual relationship. Generally, the contract standards shall adhere to the form established by the System's other equity real estate advisory contracts.

Unless specifically delegated in the contract, the Delegation and Approval Guidelines shall govern the decision-making in Portfolio investments.

V. GENERAL

- A. This Policy contains a Glossary of Terms in Section VII. of this document.
- B. The Portfolio shall be subdivided, based on investment strategy or program (e.g., timber or franchise finance). Unless otherwise delegated, Portfolio investment programs shall be approved by the System's Investment Committee ("the Investment Committee") before being implemented. Portfolio investment programs are also to be administered, subject to the adoption of specific investment policy or guidelines for each program. A list of policies for existing Portfolio investment programs are included in Appendix I of this Policy.

All calculations and computations shall be on a fair market value basis, unless otherwise noted. When reporting fair market value for accounting purposes, market value, as defined by the Uniform Standards of Professional Appraisal Practice (USPAP) of the Appraisal Foundation, shall be incorporated. The standards of the individual, specialized industries shall be followed where there are differences between USPAP and specialized sector practices (e.g., timber or agricultural land).

VI. ASSET ALLOCATION

The Portfolio shall comprise 20-50% of the target allocation to the Equity Real Estate Portfolio. The remaining 50-80% of the target allocation to the Equity Real Estate Portfolio is assigned to the Core Portfolio. From time-to-time, there may be differences between the target and actual allocation to the Equity Real Estate Portfolio. Thus, the Portfolio shall be limited to no more than 50% of the actual allocation to the Equity Real Estate Portfolio. The allocation ranges for the Core and Non Core Portfolios shall also be adjusted, on occasion, for risk-management purposes.

No individual non-core program will exceed 15% of the total real estate equity allocation. Current asset allocation ranges for the individual Specialized programs, as a percent of the total real estate equity allocation are as follows:

<u>Program</u>	<u>Range</u>
Timber Land and Agricultural Land	0-15%
Single-Family Housing Program	0-15%
California Urban Real Estate	0-15%
Alternative Strategies ¹	0-15%
Senior Housing	0-15%
International	0-15%
Specialized Securities (Extended Market PREES)	0-15%

From time-to-time, the actual investment may fall out of the ranges prescribed by Policy. In these instances, adjustments to correct the actual allocation ranges to comply with the Policy allocation ranges shall be implemented on an opportunistic basis over a reasonable time frame (normally within a three-year period) and with ample consideration given to preserving investment returns to the System.

¹ Alternative Strategies include opportunistic investment programs such as domestic and international opportunities, hotel investments and mezzanine debt investments.

As investments in the Portfolio mature, their characteristics may migrate towards a more core-like profile. The Real Estate Consultant or Staff or both shall monitor the Equity Real Estate Portfolio for instances when changes in the classification of investments from the Non Core Portfolio to the Core Portfolio are warranted. The Consultant or the Real Estate Equity unit or both shall make recommendations to the Investment Committee for approval of such reclassifications.

VII. GLOSSARY OF TERMS

The following Glossary of Terms contains definitions also referenced in the System's Master Glossary of Terms.

National Council of Real Estate Investment Fiduciaries Index ("NCREIF Index") – A property level performance benchmark for institutionally owned real estate. The benchmark is composed of an Income Return, an Appreciation Return and a Total Return and is calculated on a quarterly basis.

NCREIF – National Council of Real Estate Investment Fiduciaries.

USPAP – Uniform Standards of Professional Appraisal Practice (USPAP) of the Appraisal Foundation may be referenced for a standard definition of "market value" or "fair market value" for accounting purposes.

WRESI - Wilshire Real Estate Securities Index.

Appendix I**Policy List for Specialized ("Non Core") Real Estate Equity Portfolio Investment Programs**

- A. Statement of Investment Policy for Franchise Finance Real Estate;
- B. Statement of Investment Policy for International Real Estate;
- C. Statement of Investment Policy for Agricultural Land Real Estate;
- D. Statement of Investment Policy for California Urban Real Estate;
- E. Statement of Investment Policy for Timber Real Estate;
- F. Statement of Investment Policy for Single Family Housing Program;
- G. Statement of Investment Policy for Extended Market Public Real Estate Equity Securities (Extended Market PREES); and
- H. Statement of Investment Policy for Senior Housing.